United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 12928

ESTATE OF HERBERT B. HATCH, *Deceased,* Juanita O. Hatch, Executrix and American Trust Company, Executor; JUANITA O. HATCH and HERBERT B. HATCH, JR., *Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition to Review a Decision of the Tax Court of the United States.

BRIEF FOR PETITIONERS.

FREDERIC D. DASSORI,
DEE R. BRAMWELL,
1101 Connecticut Ave.,
Washington 6, D. C.

Of Counsel:
EDWIN A. MOOERS, JR.
STOKES, BRAMWELL AND DASSORI,
Washington 6, D. C.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX.

CITATIONS.

TABLE OF CASES:

United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 12928

Estate of Herbert B. Hatch, *Deceased,* Juanita O. Hatch, Executrix and American Trust Company, Executor; Juanita O. Hatch and Herbert B. Hatch, jr., *Petitioners,*

vs.

Commissioner of Internal Revenue, *Respondent.*

On Petition to Review a Decision of the Tax Court of the United States.

BRIEF FOR PETITIONERS.
JURISDICTION.

This petition for review (R. 78-87) involves alleged deficiencies in Federal Income taxes against (1) Herbert B. Hatch, now deceased, for the taxable year from January 1, 1944, to April 9, 1944, in the amount of $3,702.31; (2) Juanita O. Hatch for the taxable year ending December 31, 1944, in the amount of $2,199.38; and Herbert B.

Hatch, Jr., for the taxable year ending December 31, 1944, in the amount of $187.22. On February 20, 1948, the Commissioner of Internal Revenue mailed to the taxpayers notices of deficiencies in the respective amounts above set forth. (R. 14, 24, 34) Within ninety days thereafter, on May 17, 1948, the taxpayers filed their respective petitions with the Tax Court for a redetermination of those deficiencies (R. 3-38) under the provisions of Section 272 of the Internal Revenue Code. The petitions were consolidated for hearing before that Court (R. 4, 6, 8). The decisions of the Tax Court sustaining the said deficiencies were entered December 28, 1950 (R. 75, 76, 77). The cases were brought to this Court by a petition for review filed March 23, 1951 (R. 78-87), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code, (28 U.S.C. Sections 1141, 1142) and by stipulation (R. 89-90) were consolidated for purposes of review herein.

VENUE.

Herbert B. Hatch, deceased, and Petitioners Juanita O. Hatch, his wife, and Herbert B. Hatch, Jr., their son, were residents of Stockton, California, in 1944 and their Federal Income Tax returns for 1944 were filed with the Collector of Internal Revenue for the First District of California at San Francisco, California. (R. 10, 11, 21, 31)

Juanita O. Hatch and American Trust Company were and are duly appointed Executrix and Executor, respectively, of the last Will of Herbert B. Hatch, by authority of letters testamentary issued by the Superior Court of the County of San Joaquin, State of California. (R. 4, 10, 71, 79, 81)

The places of residence of each petitioner and the office of the said Collector were and are within the territorial jurisdiction of the United States Court of Appeals for the Ninth Circuit. (R. 10, 21, 31)

The Respondent on review is the duly appointed, qualified, and acting Commissioner of Internal Revenue of the United States. (R. 79)

STATEMENT OF THE CASE.

This case was tried in the Tax Court of the United States on stipulated facts. (R. 40)

On December 1, 1942, in Stockton, California, Herbert B. Hatch, now deceased, Juanita O. Hatch, his wife, and Herbert B. Hatch, Jr., their son, entered into a written agreement of co-partnership to engage in "the business of selling, distributing, repairing and servicing motor vehicles and motor vehicle parts" (R. 45, 46) under a franchise from the Chevrolet Motor Division, General Motors Corporation.

The original co-partnership assets were those received on liquidation of Hatch Chevrolet Company, a corporation. They constituted the capital contribution to the partnership of each co-partner's undivided interest in those assets as follows:

Herbert B. Hatch	40/75ths	
Juanita O. Hatch	29/75ths	
Herbert B. Hatch, Jr.	6/75ths	(R. 46)

The interests of all parties in the partnership remained the same throughout the duration of the partnership.

Herbert B. Hatch, Jr., was a member of the United States Army Air Corps on October 9, 1942 and on that date executed a general power of attorney to his father, Herbert B. Hatch. (R. 41)

On February 16, 1944, Petitioners as co-partners agreed to sell to King Chase their interests or the assets of the partnership (as the Court may determine), (R. 51), the transaction to be escrowed until an inventory and appraisement could be made to determine the value of the interests or assets of the partnership (as the Court may determine). (R. 52) The Agreement (R. 51) further

provided, however, that the purchaser "shall take over possession of the physical assets of the business at 8 o'clock a.m. on Monday, February 21, 1944, and thence forward shall operate said business to all intents and purposes as though this transaction had been completed and title thereto passed to the" purchaser. (R. 52)

"Upon taking possession", the purchaser was given "permission to *operate the business under the name of Hatch Chevrolet Company* for a limited period of time to enable him to make the necessary arrangements for the future title or trade name of said business." (R. 52) (Emphasis supplied)

Subsequently, on March 3, 1944, the Petitioners "as co-partners" executed a bill of sale to the said purchaser pursuant to the terms of the said agreement of sale which was referred to and made a part thereof. (R. 56, 57)

The following assets and liabilities were excluded from the sale: (1) cash in bank in the amount of $35,249.90, (2) two automobiles having a book value of $1,542.66, (3) certain liabilities, in the amount of $15,588.55, not assumed by the purchaser (R. 42).

At the time of the execution of the Agreement of Sale on February 16, 1944, Chase paid $5,000.00 of the purchase price (R. 41) and at the time of the execution of the Bill of Sale on March 3, 1944, Chase paid the remainder of the purchase price in the amount of $161,807.77. (R. 42) This latter payment was made by check payable to the order of the Hatches, "Co-partners", and was deposited in the bank account of the Hatches "Co-partners". (R. 60) Partial distributions were made to the petitioners beginning in June 1944 (R. 43). $5,000.00 was withheld by Chase as a reserve against bad debts and was subsequently refunded by him. (R. 42)

In the transaction between the parties there was never any distribution of assets in kind to the partners prior to the sale. (R. 42)

The total cost basis to the partners of the interests of the partners or the assets (as the Court may determine)

which were transferred was $125,138.70 and the gain on the sale was $36,669.07. (R. 42)

Herbert B. Hatch died on April 9, 1944, and his wife and the American Trust Company were appointed Executors of his estate. (R. 4, 10, 42, 71)

An amended partnership information return of income (Form 1065) for the fiscal year beginning July 1, 1943, and ending June 30, 1944, was filed by the Hatch Chevrolet Company with the Collector of Internal Revenue for the First District of California on September 19, 1944 (R. 43). The amended return reported an ordinary net income in the amount of $75,444.43 and a long term capital gain from sale of business in the amount of $36,669.07, $18,334.54 of which was to be taken into account. In Schedule J of said amended return the partnership reported the partners' shares of income and credits in proportion to their individual interests in the partnership as follows: (R. 43)

	Ordinary Income	*Long Term Capital Gains*	*Charitable. Contributions*
H. B. Hatch	$42,337.04	$ 9,778.42	$213.33
Juanita O.Hatch	27,431.85	7,089.35	154.67
H. B. Hatch, Jr.	5,675.54	1,466.77	32.00
	$775,444.43	$18,334.54	$400.00

Petitioners duly filed their respective individual income tax returns and therein claimed long term capital gains in the amounts shown in the amended partnership information return above set forth. (R. 44)

Respondent challenged the treatment of the sale and allowed a long term capital gain in the amount of $22,-486.36 (recognized to the extent of $11,243.18), determined that the gain from the sale in the amount of $14,-182.71 was ordinary income from the sale of the property other than capital assets, and made corresponding proportionate adjustments in the individual incomes of the partners on the ground that the transaction constituted

a sale by the partnership of assets held pursuant to its business and that a portion of the net gain realized thereon was reportable as ordinary income. (R. 16-19, 26-29, 36-38)

Petitioners each petitioned the Tax Court for a redetermination of the alleged deficiency and after a hearing, that Court, on February 23, 1950, rendered an opinion (R. 67) which sustained the Respondent. On December 28, 1950, an order was entered by the Court in accordance with said opinion (R. 75, 76, 77).

SPECIFICATION OF ERRORS.

The Court erred:

1. In holding and deciding that the partners made no effort to sell, and Chase did not buy their individual interests in the partnership or any part of those interests. (R. 85)

2. In holding and deciding that the subject of the sale to Chase was merely a part of the partnership assets subject to a part of the partnership liabilities. (R. 85)

3. In holding and deciding that because the partnership distributed to the individual partners some of its assets and the amount realized from the sale, the gain realized from the sale should not be taxed to the partners as capital gain resulting from the sale of their partnership interests. (R. 85)

4. In holding and deciding that the gain was computed on the partnership return as a gain from a sale by the partnership of some of its assets, and that the part of the gain resulting from the sale of assets which were not capital assets of the partnership, was ordinary income. (R. 85)

5. In holding and deciding that there is no method for Federal tax purposes of computing a capital gain to a partner for his partnership interest where the sale of the

partnership interest involves some, but not all of the partnership assets. (R. 86)

6. In failing to find, hold and decide that the sale to Chase of the assets of the partnership as a going business was not a sale by the partnership in the ordinary course of its business, but a sale by the individual Petitioners of their individual interests in the partnership, which were capital assets. (R. 86)

7. In that its opinion and decision are contrary to the uncontroverted evidence in this proceeding. (R. 86)

8. In that its opinion and decision in this proceeding are contrary to law. (R. 86)

SUMMARY OF ARGUMENT.

1.) The sale by the partners was a sale of each partner's interest in the partnership.

(a) The transaction was in substance and effect a sale of the partnership interests.

(b) The exclusion of certain assets and liabilities from the sale did not preclude the transaction from being a sale of partnership interests.

(c) The sale terminated the partnership and that which transpired after the sale was not the conduct of business but was incident to the distribution between Petitioners of the proceeds of the sale or in aid thereof.

2) The profit from the sale is taxable to the individual partners as capital gain.

ARGUMENT.

I

The Sale by the Partners Was a Sale of Each Partner's Interest in the Partnership.

The stipulated facts and the Exhibits in support thereof (R. 40-66) submitted in this case admit of only one logical construction in regard to the intention of the parties to the agreement of sale. This intent was clearly a sale of the interests of the three partners in the partnership business and a merger of those interests in the purchaser.

Everything done by the parties in consummation of the sale and in distribution of the proceeds of the sale to the former partners was consistent with this intention.

The Tax Court's construction is contrary to the facts and clearly erroneous as a matter of law.

(a) The transaction was in substance and effect a sale of the partnership interests.

Prior to the sale transaction in question, on December 1, 1942, the three Petitioners entered into a partnership agreement, as co-partners, for the purpose of operating an automobile dealership (R. 45-51). The capital contribution to the partnership of each co-partner was his undivided interest in the assets of a liquidated corporation (R. 46).

On February 16, 1944, the same three Petitioners entered into an agreement of sale with King M. Chase. They agreed to sell and Chase agreed to buy "all of the business and assets of Hatch Chevrolet *Company*, a copartnership, hereinafter listed," escrowing the transaction until a final inventory to determine the value of the interests. However, they agreed to give Chase possession of the physical assets of the business within five days as if the transaction had been completed, and permitted him to operate the business under the name of Hatch Chevrolet Company until he had arranged for a trade name (R.

51-55). On March 3, 1944, after Chase had taken over the business, the three Petitioners executed a Bill of Sale, (R. 56-59) conveying to Chase all of the assets of the Hatch Chevrolet Company, with the exception of cash in bank, two automobiles, and certain liabilities.

Everything else necessary to conduct the business for which the partnership had been formed (with the exception of the franchise from Chevrolet Division, General Motors Corporation, which was not transferable) was transferred to the Buyer.

The legal nature of the subject matter of the sale permits no logical conclusion other than that the partnership interests were transferred.

The articles of partnership were entered into, and the contract of sale was made and executed, in the State of California. The applicable law as to the respective rights of the several partners is therefore the law of California. (*Estate of Daniel Gartling* v. *Commissioner*, Docket No. 8795—T. C. Memo 1947, aff'd 170 F. (2d) 73; *Lehman* v. *Commissioner*, 7 T. C. 1088, aff'd. 165 F. (2d) 383; *Blair* v. *Commissioner*, 31 B. T. A. 1192, rev'd. 90 F. (2d) 1004, rev'd. 300 U. S. 5).

The State of California adopted the Uniform Partnership Act on August 14, 1929. (California Civil Code Sections 2395 et seq.)

It is elementary that the assets of the partnership are the property of the firm and that the partners have no individual property rights therein. This was well stated by Judge Learned Hand in *Commissioner of Internal Revenue* v. *Lehman*, 165 F. 2d. 383, where, after reviewing the development of partnership concepts in the common law, he said:

"The Uniform Partnership Law codified this congeries of rights and obligations as it had developed; and made no substantial change, when it declared in so many words that 'a partner's interest in the partnership is his share of the profits and surplus.' (Sec. 52, New York Partnership Law, Consol. Laws, c. 39)"

The section of the Uniform Act to which reference is made is contained in the California Civil Code as Section 2420 and reads:

> "Nature of Partner's Interest in Partnership. A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property."

In *Clarke* v. *Kiedler,* 113 P. 2d 275, 44 Cal. App. 2d 838, the court construed the statute as declaratory of the common law and to mean that the interest of one partner in the assets of the partnership does not entitle him to any particular portion of such assets, but merely confers upon him a right to an account with other members of the partnership and when the affairs of the partnership are settled to receive the share to which he is entitled.

In fact an assignment by a partner of all of his interest in the partnership does not create the assignee a partner with the other partners nor vest in him title to any specific partnership property. Such assignment "merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled". (California Civil Code Section 2421)

When the entire sale transaction is analysed it is to be remembered that the substance and effect of the transaction, rather than its form, is the appropriate test has been uniformly recognized by the courts. In *United States* v. *Phillis,* 257 U. S. 156, 168, 42 S. Ct. 63, 65, the rule was stated as follows:

"We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases besides those just cited we have under varying conditions followed the rule. *Lynch* v. *Turrish,* 247 U. S. 221; *Southern Pacific Company* v. *Lowe,* 247 U. S. 330; *Gulf Oil Corporation* v. *Lewellyn,* 248 U. S. 71".

In *Paxson* v. *Commissioner of Internal Revenue,* 3 Cir. 144 F. 2d 772, 776, it is said:

"Taxation deals with realities not semblances; with substance not form. As we stated in *Berwind* v. *Commissioner of Internal Revenue,* 3 Cir., 137 F. 2d 451, 453, 'It is a well settled rule of tax law that the substance of transactions will prevail over form, * * *'. The basis of the doctrine is the common-sense view that taxation 'is an intensely practical matter.' "

These were the views expounded and followed in *Thornley* v. *Commissioner of Internal Revenue,* 3 Cir., 147 F. 2d 416, in holding that an exchange was a transfer of partnership interests and not of partnership assets. The similarity between the *Thornley* case, supra, and the instant case deserves attention.

The taxpayer, Thornley, was a member of a partnership formed in 1927 to engage in the advertising business. In 1929, the partners decided to incorporate. They executed a bill of sale to the corporation wherein the five partners, describing themselves as "co-partners trading as N. W. Ayer & Son" (just as the petitioners in the instant case described themselves in their Bill of Sale as "co-partners transacting business under the firm name and style of Hatch Chevrolet Company") (R. 56).

Whereas the contract of sale in the *Thornley* case purported to convey "all assets and property of the partnership", there was nevertheless excluded from the transfer the undistributed profits which were standing to the credit of the respective partners on the partnership books (just as there was exempt from transfer in the instant case, the cash on hand and certain other minor assets (R. 42)).

The Commissioner contended in that case, as in this, that the partners had conveyed to the corporation the assets of the partnership and not their individual partnership interests in the partnership. The decision of the Tax Court sustaining the Commissioner (*Thornley* v. *Commissioner,* 2 T. C. 220) was reversed by the Court of Appeals, Third circuit.

That Court stated that "* * * it is clear that the subject matter of the direct exchange between the partnership and the corporation was the partnership interest in the entire business and its physical assets, real and personal *as a going concern*" (emphasis supplied).

In the instant case the transfer was of the business "as a going concern". This is clearly evidenced by the provisions of the Contract of Sale that the purchaser should "take over possession of the physical assets of the business at 8 o'clock a. m. on Monday, February 21, 1944, and thence forward *shall operate said business* * * *" (R. 52) (Emphasis supplied) Such intent is further evidenced by the provision of the Bill of Sale that the purchaser should "upon taking possession, have permission *to operate the business* * * *" (R. 52) (Emphasis supplied). The Contract of Sale refers to the "sales price *of said business* * * *" (R. 52) (Emphasis supplied). It is further evidenced by the provision of the sales contract requiring the purchaser to indemnify and save harmless the former partners "from any obligation, liabilities or detriment whatsoever" that might accrue to them "during the period that said party *operates said business* under the firm, name and style of Hatch Chevrolet Company" (R. 54) (Emphasis supplied).

After citing *United States* v. *Phillis*, supra, *Tex-Penn Oil Company* v. *Commissioner,* 83 F. 2nd 518, aff'd 300 U. S. 481, and *Paxson* v. *Commissioner,* supra, to the effect that in cases of this character courts must look to the substance of the transaction, the court in the *Thornley* case continued:

> "The critical test is not whether the corporation technically acquired the 'partnership interest' but, as was pointed out in *Kessler* v. *United States,* supra, *whether the petitioner gave up 'his partnership interest in exchange for the stock even though that interest as such did not pass to the corporation'.* Here clearly the petitioner and his co-partners acting in concert gave up his partnership interest in exchange for the stock of the corporation" P. 422, (Emphasis supplied by the Court).

It would be difficult to find more apt language to characterize the situation presented in the instant case. The Tax Court opinion makes no reference to the *Thornley* case. In fact, the Court did not cite any authority for its conclusion on the main point involved.

It might also be noted that the Tax Court in reaching its conclusion refers to the fact that the partnership made a return showing the fact of sale. Without pausing to emphasize that a partnership return is merely an information return and that a partnership is not a tax paying entity, it is to be noted that the record states that "In said amended return the partnership reported an ordinary net income in the amount of $75,444.43 and a long-term capital gain *from sale of business* in the amount of $36,669.07, $18,334.54 of which was to be taken into account" (R. 43) (Emphasis supplied).

The Tax Court opinion disregards the emphasized language and erroneously states "However, the gain was computed on a partnership return as a gain from a *sale* by the partnership *of some of its assets* * * *" (R. 73) (Emphasis supplied).

The amended partnership return reveals further evidence of the intent of the partners and is indeed striking evidence of the "substance and effect" of the transaction.

Since the Commissioner of Internal Revenue in an opinion of May 17, 1950, (footnote post page 22), concedes that "the overwhelming weight of authority is contrary to the position heretofore taken by the Bureau viz, that the sale of a partnership interest is a sale of the selling partner's undivided interest in each partnership asset", petitioner will not labor the point but adopts the cases well cited in the Commissioner's opinion:

Estate of Daniel Gartling v. *Commissioner*, Docket No. 8795, T. C. Memo 1947, aff'd. 170 F. 2d 73

Ford v. *Commissioner*, 6 T. C. 499

Humphrey v. *Commissioner*, 32 B.T.A. 280

Lehman v. *Commissioner*, 7 T. C.1 088, Aff'd. 165 F. 2d 383, cert. denied 334 U. S. 119, 68 Sup. Ct. 1085

Shapiro v. *Commissoiner*, B. T. A. Memo Dec. 1940, Aff'd. 125 F. 2d 532

Smith v. *Commissioner*, 10 T. C. 398, Aff'd. 173 F. 2d 470, cert. denied 338 U. S. 818

Thornley v. *Commissioner*, 2 T. C. 200, Rev'd. 147 F. 2d 416

Whitney v. *Commissioner*, 8 T. C. 1019, Rev'd. 169 F. 2d 562, cert. denied 335 U. S. 892.

(b) The exclusion of certain assets and liabilities from the sale did not preclude the transaction from being a sale of partnership interests.

The Tax Court predicated its decision almost entirely upon the fact that certain partnership assets and liabilities were excluded from the sale. Such a determination is certainly contrary to that in the *Thornley* case supra, in which, under a similar sales contract, the exclusion of assets from the transfer did not prevent the sale from being that of the partnership interests.

Certain assets owned by the Hatch partnership and used in the business were retained by the sellers. These are stipulated to have been:

1. Cash in bank in the amount of $35,249.90.
2. Two automobiles having a book value of $1,542.66
3. Certain liabilities in the amount of $15,588.55. (R. 42)

The Tax Court found that all of the assets of the partnership were transferred except:

1. The General Motors franchise.
2. Two automobiles.
3. Cash in a substantial amount.
4. The partnership name.

And that Chase assumed a part but not all of the liabilities. (R. 70)

The facts stipulated and the Tax Court additions are discussed separately.

(1) *Retained cash.* At the time the business was sold the partnership had cash to its credit in the bank.

To use this fact of excluding this cash from the sale as the basis of a conclusion that the partners did not sell, nor did the purchaser receive, the individual interests of the partners is completely unrealistic. Such a conclusion overlooks the fact that the transaction was a cash sale, as shown in the agreement of sale (R. 52), the bill of sale, and the actual payment of $161,807.77 by the purchaser to the petitioners (R. 60).

It would be patently contrary to established commercial custom and usage for the purchaser to have "purchased" the cash in bank by the payment of an equal amount in cash. To have included this sum as a transferred asset would merely have resulted in adding an equivalent amount to the purchase price upon the receipt of which, both the vendors and the purchaser would have been in exactly the same position as the contract actually left them. Neither the purchaser nor the partners would have received or parted with one cent the more or less. This was a practical bookkeeping transaction and to seize upon it as having any evidentiary value is grasping at a straw.

(2) *Retained Automobiles.* To infer from the exclusion from the sale of two second hand automobiles that petitioners did not sell their partnership interests and intended to continue the conduct of a business which they had just sold is but another instance of straining at the proverbial gnat.

It can hardly be contended that the retention of these assets with a value of $1,542.66 in a sale involving approximately $160,000.00 is sufficient to continue the former partners "in the business of selling, distributing, repairing and servicing motor vehicles and motor vehicle parts both at wholesale and retail."

[Obviously, the two used automobiles were the automobiles used by the Petitioners for their personal use. Exclusion of these cars from the sale amounted in effect

to nothing more than Petitioners' purchase from the business, since the amount Petitioners received from the sale was reduced by the amount they would have to pay for these two cars.]

In the absence of a showing in the evidence and a finding by the court that the retention of the two used automobiles was for the purpose of continuing the partnership in business for its stated purpose, the conclusion, that because of this retention the partnership was not terminated, is illogical, unreasonable and unwarranted.

(3) *Retained Liabilities*: The retained liabilities were incurred by the partnership prior to the date of sale of the business, and as such, under common business practice, their exclusion from the transfer is perfectly consistent with the provision in the Bill of Sale that

> "the parties of the First Part continue to hold and assume any and all liabilities arising from the operation of the Hatch Chevrolet Company prior to that hour and date [8 a.m. on Monday, February 21st, the date on which the purchaser had assumed control of the business under the Agreement of Sale] except such specific liabilities as have been assumed in writing by said Party of the Second Part."

Those liabilities assumed by the purchaser under the Agreement of Sale included:

1. Accounts receivable, credit balances.
2. Service contract deposits.
3. Employer War Bonds.

Each of these items is in the nature of a *continuing liability* which would logically be expected to go with a continuing business, since the credit balances would probably be extinguished by further debit transactions with current customers; since service contract deposits carried an obligation to perform the services which the deposits guaranteed; and since the War Bonds would be possessed by the employees for whom they were purchased. The assump-

tion of all three evidences the discontinuance of the business by the Petitioners and its continuance by the Purchaser and does not preclude the transaction from being a sale of the partnership interests.

The exclusion of other liabilities incurred in the operation of the business prior to its transfer is perfectly consistent with the sale, since the Purchaser would not be expected to assume obligations incurred prior to his operation of the business as a single proprietorship and since, even if he did, it would be merely a question of his discharge of these liabilities for the Sellers and a consequent reduction of the purchase price by the amount he would have to pay for them.

Furthermore, the consent of the creditors would have to be secured for the substitution of debtors under established contract law. The Petitioners could not relieve themselves of liability by transferring the debts to another. Their retention of liability, therefore, was merely declaration of what devolved upon them by operation of law.

(4) *Retained Franchise*: The Tax Court evidently attached weight to the failure to transfer the General Motors franchise and the firm name as proving the retention of sufficient assets to continue the partnership in business.

The evidence introduced into the record is completely silent as to the disposition of the General Motors franchise. The only evidence of the existence of the franchise is a statement at the end of the Stipulation of Facts that prior to the date of sale, the Hatch Chevrolet Company operated its business under a franchise from the Chevrolet Motor Division, General Motors Corporation (R. 45).

The franchise was not mentioned in the Agreement of Sale (R. 51) or Bill of Sale (R. 56), nor was it stipulated to have been among the assets withheld from the sale (R. 40-45).

The Tax Court's deetrmination, therefore, that it was an asset of the partnership which was not transferred is without value and without basis in the record.

(5) *Retention of firm name.* The agreement of sale provides: "Second party shall, upon taking possession, have permission to operate the business under the name of Hatch Chevrolet Company for a limited period of time to enable him to make the necessary arrangements for the future title or trade name of said business" (R. 52).

The fact that the sellers, as a part of the consideration of the sale, required that the existing firm name be discontinued in the future is in no conceivable way inconsistent with the sale of partnership interests. And, contrary to the determination of the Tax Court, the use of the existing firm name by the purchaser for any period of time is convincing evidence that the former partners did not in any way continue in the business for which the partnership was formed.

The "critical test" overlooked by the Tax Court is not what the partners retained but, as stated in *Thornley* v. *Commissioner* supra, "whether the petitioner gave up 'his partnership interest' ". The transaction was in substance and effect the sale of a partnership interest and the nature of the sale could not be altered merely because minor assets were withheld from the transaction.

(c) The Sale Terminated the Partnership and That Which Transpired After the Sale Was Not the Conduct of Business But Was Incident to the Distribution Between Petitioners of the Proceeds of the Sale or in Aid Thereof.

The Tax Court, in its opinion, first raised the issue of whether the partnership was terminated by the sale. The Court said:

> " . . . the subject of the sale was a part of the partnership assets subject to a part of the partnership liabilities. *The partnership was not terminated* by the sale. It retained some of its assets and the amount realized from the sale. Later it distributed its assets to the individual partners in liquidation." (Emphasis supplied) (R 74)

This expression reveals that the Tax Court determined to characterize the sale as though assets subject to liabilities were sold to a customer in the ordinary course of business and that the partnership retained sufficient assets to remain in business as well as in existence.

Such a determination could result only from a misinterpretation of the facts and of the law. It is apparent that the Tax Court placed an unwarranted emphasis upon the fact that minor assets were retained by the former partners and that distribution to petitioners of the proceeds of the sale was required.

Under the Uniform Partnership Act, in force in California at the time the partnership was formed and at the time the partners sold their assets and business to Chase, a partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit." (Calif. Civil Code, Sec. 2400(1).) The intention of the parties to carry on as co-owners a definite business is ultimately the test of partnership. Witkin, *Summary of California Law* (6th ed.) p. 1259.

That test produces a negative result when applied to the association of these Petitioners after the sale to Chase. Having associated themselves to carry on as co-owners the business of selling, distributing, repairing and servicing motor vehicles and motor vehicle parts both at wholesale and retail, for profit, they divested themselves of their interests in this definite business. The sale resulted in the purchaser obtaining the complete inventory of new, used and service cars (with the exception of two used cars worth $1,542.66 out of a total inventory of $23,194.79), the complete inventories of parts, accessories, tires and other service materials, all work in process, the machinery, shop and service equipment, furniture and fixtures, all other fixed assets, and in addition, the firm name to be used by the purchaser for an indefinite period of time.

Petitioners retired from the business of selling, distributing, repairing and servicing motor vehicles and motor

vehicle parts, both at wholesale and retail under the firm name of Hatch Chevrolet Company.

What did they do thereafter?

There is no showing that they continued or resumed the business in which they had associated themselves to engage. The minor assets, withdrawn from the sale, as previously discussed herein, were not retained for the purpose of continuation of such business. Those assets were logically withheld to decrease the sales price of each partner's interest and for the convenience of both parties to the transaction.

Partnerships are terminated by the will of the partners—not by the mechanics of payment for their interest. Yet, in the instant case, it was the mechanics of distribution to petitioners of the proceeds of the sale which disturbed the Tax Court.

Subsequent to the sale, the Tax Court found the following transactions to have taken place:

> (1) The purchaser's check was credited to the bank account of the Hatches, "Copartners."
>
> (2) Partial distributions were made to them by checks drawn on that account beginning in June, 1944.
>
> (3) The sale was reported and the gain computed on the partnership return for its fiscal year as a partnership transaction.

It is submitted that none of these things occurring after the sale to Chase vitiates the intention of the partners, expressed in the sale, to dispose of their partnership interests, but that all are consistent with that intention and were proper distributions of the proceeds of the sale or were in aid of such distribution.

The deposit and crediting of the check to the joint checking account of the Hatches, "co-partners," did not serve to effect a revival or a continuance of the partnership business— unless it be construed that the Hatches were in partnership to carry on the business of owning bank accounts

(although it would be difficult to add "for profit" which the definition of a partnership requires).

The holding of the former partners' joint bank account open to receive this final item of consideration and for the purpose of distributing the proceeds to petitioners was an expedient which in no way could alter the fact that the partners had ceased to own the business for which they had associated themselves.

The information contained on the partnership *information* return, as previously discussed herein, evidences the nature of the transaction described as the "sale of the business" (supra p. 13).

Petitioners contend that the transaction was the sale of partnership interests and termination of the partnership would result as a matter of law. Certainly dissolution by the "express will of all of the partners . . ." [California Civil Code, Section 2425(1)] resulted when all "co-partners transacting business under the firm name and style of Hatch Chevrolet Company" (R. 51) agreed to and did sell "all of the business and assets of Hatch Chevrolet Company" to one individual (R. 51).

It appears that the Tax Court in this case has confused "termination" of the partnership with the subsequent liquidation, between former partners, of their respective shares of the proceeds received from the sale of their partnership interests.

The distribution between petitioners of the proceeds of the sale did not alter the fact that the sale terminated the partnership.

(2) THE PROFIT FROM THE SALE IS TAXABLE TO THE INDIVIDUAL PARTNERS AS CAPITAL GAIN.

It has been consistently held that the property right of a partner is an undivided interest in the partnership and that the interest which is his share in the profits and surplus after the partnership debts have been paid, is a capital asset. (*Lehman* v. *Commissioner,* supra; *Estate of Gart-*

ling, supra; *H. R. Smith* v. *Commissioner,* supra; *Thornley* v. *Commissioner,* supra.)

Each partner therefore holds his undivided interest in the partnership as a capital asset.

If a partner sells his interest to another party it is the sale of a capital asset. (*H. R. Smith* v. *Commissioner,* supra; *Estate of Gartling* v. *Commissioner,* supra; *Lehman* v. *Commissioner,* supra).

If a partner sells his interest to his co-partner it is the sale of a capital asset. (*Shapiro* v. *Commissioner,* 125 F. 2nd 532).

If a partner, in conjunction with his other partners sells his interest to a third party, then that sale is the sale of a capital asset. (*Thornley* v. *Commissioner,* 2 T. C. 220, rev'd 147 F (2d) 416)

From the time of the enactment of the Revenue Statute until May 17, 1950, the Commissioner of Internal Revenue contended that a sale of a partnership interest was a sale of the individual partner's undivided interest in each partnership asset. He persisted in that contention long after it had been uniformily rejected by the courts.

On May 17, 1950, the Bureau of Internal Revenue, in a memorandum of its General Counsel, finally conceded that his ruling that a sale of a partnership interest was not the sale of a capital asset under the provisions of Section 117 of the Internal Revenue Code was contrary to "the overwhelming weight of authority" and promulgated GMC 26379.** The opinion then proceeds to attempt to distin-

** "An opinion is requested whether, for Federal income tax purposes, the Bureau should continue to treat a sale of a partnership interest as a sale of the selling partner's undivided interest in each specific partnership asset.

"The overwhelming weight of authority is contrary to the position heretofore taken by the Bureau, viz, that the sale of a partnership interest is a sale of the selling partner's undivided interest in each partnership asset. (See *Adam Kessler, Jr.* v. *United States,* 124 Fed. (2d) 152; *Commissioner* v. *Morris Shapiro,* 125 Fed. (2d) 532; *George H. Thornley et ux.* v. *Commissioner,* 147 Fed. (2d) 416; *Commissioner* v. *Estate of Daniel Gartling et al.,* 170 Fed. (2d) 73; *Commissioner* v. *Allan S. Lehman,* 165 Fed. (2d) 383, certiorari denied, 334 U. S. 819 (Report No. 96 of 5/17/48); *Commissioner* v. *H. R. Smith,* 173 Fed. (2d) 470 (Report No. 77 of 4/21/49) certiorari denied, October 10, 1949; *L. F. Long* v. *Commissioner,* 173 Fed. (2d) 471, certiorari denied, October 10, 1949 (Report No. 196 of 10/10/49); *Max Shapiro* v. *United States,* 83 Fed. Supp. 375; contra: *City Bank Farmers Trust Co. et al., (Housman Will)* v. *United States,* 47 Fed. Supp. 98). See also *Robert E. Ford et al.* v. *Com-*

guish the instant case from the foregoing opinion "that the sale of a partnership interest should be treated as the sale of a capital asset under the provisions of Section 117 of the Internal Revenue Code" by stating that "the application of this rule should, of course, be limited to those cases in which the transaction in *substance and effect,* as distinguished from *form and appearance,* is essentially the sale of partnership interest. (See Estate of *Herbert B. Hatch et al.* v. *Commissioner,* 14 T.C. 251)." (Emphasis supplied)

The Commissioner thus very properly posed the issue here pending for decision which petitioners have argued throughout this brief.

Petitioners agree with the Commissioner that the form which the transaction took was the sale of partnership interests. They also submit that, even more than in the cases cited in the General Counsel's memorandum, the effect and the substance of the transaction was the sale of partnership interests.

There is no rational basis for the General Counsel's attempt to distinguish this case from the unbroken line of Tax Court and Circuit Courts of Appeals decisions holding against the Commissioner.

Perhaps the most concise discussion of the rationale of the case is to be found in *Lehman* v. *Commissioner,* supra, where the genesis of the so-called entity theory of partnerships is discussed by Judge Learned Hand.

He there concludes that, even prior to the Uniform Partnership Act, the law had long been established that "in the administration of its affairs it [a partnership] did become

---

missioner (6 T.C. 499, acquiescence, C.B. 1946-2,2) (Report No. 241 of 12/5/46) wherein the court (consistent with the views expressed in the above-cited cases that a partnership interest is a capital asset and that gain or loss realized upon the sale of such an interest is capital gain or loss) held that the basis for computing gain or loss on an asset purchased by a partnership and sold after the retirement of one of the partners was the original cost of such asset when acquired by the firm.

"It is accordingly the opinion of this office that the sale of a partnership interest should be treated as the sale of a capital asset under the provisions of section 117 of the Internal Revenue Code . . ."

for most purposes an entity.'' Rejecting the theory of the Court of Claims in the City Bank case, supra, and accepting that of *Thornley* v. *Commissioner,* supra, wherein the Third Circuit had held that several partnership interests were merged in a purchasing corporation.

The case at bar fits the rationale of these leading cases on the subject of taxation of the proceeds of the sale of a partnership interest and is not distinguishable in any essential charactertistic from those cases.

To argue that the transaction was without reality, whereas it was real when the partners simply exchanged their ownership of the business for stock of an identical value, is to make a mockery of the words ''substance and effect'' and ''form and appearance,'' as applied to economic realities.

The essential thing in cases of this character is that the partner disposed of his ownership interest in a business, and thereafter did not draw the share of the profits to which that interest was entitled. The partners in *Thornley,* supra, sold their interest to the corporation and thereafter were no longer engaged in that business as partners. The partners in *Lehman,* supra, sold a part of their interests to new partners and no longer shared in the profits in the former proportion. *Smith,* supra, sold his interest to the remaining partners and withdrew from the business, receiving no more of the profits thereof.

This case is the same. After the date of the sale to Chase, there were no more profits from the business accruing to the partners—for there was no longer any partnership business to create a profit or a loss. The business was in Chase's hands, and he alone or his assignee was entitled to the profits therefrom.

The former partners had retired from business for a profit on the date of the sale. They did not even have the use of the partnership name.

CONCLUSION

There was no conflicting evidence to be resolved by the Tax Court. The case was heard on stipulation and written exhibits.

In *Thornley* v. *Commissioner,* supra, the court said "....the function of the Tax Court, *as of this court,* was to construe the nature of the transaction and such construction is a matter of law". (Emphasis supplied).

It is respectfully submitted that the sale by the partners was the sale of partnership interests and, therefore, the decision of the Tax Court should be reversed.

Frederic D. Dassori,
Dee R. Bramwell,
Counsel for Petitioners.

APPENDIX

STATUTES INVOLVED

Internal Revenue Code:

"Sec. 117. Capital Gains and Losses:

(a) Definitions—As used in this chapter—

(1) Capital assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the usual course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23(L), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed rate maturity date not exceeding one year from the date of issue or real property used in the trade or business of the taxpayer.

* * * * * * * * *

(b) Percentage Taken Into Account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 percentum if the capital asset has been held not more than 6 months;

50 percentum if the capital asset has been held for more than 6 months."

Sec. 1141. Courts of Review:

(a) The courts of appeals shall have exclusive jurisdiction to review the decisons of the Tax Court, except as provided in section 1254 of title 28 of the United States

Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of title 28 of the United States Code. As amended May 24, 1949, c. 139, sec. 128, 63 Stat. 107.

(b) Venue:

(1) In general. Except as provided in paragraph 2, such decisions may be reviewed by the Circuit Court of Appeals for the circuit in which is located the collector's office to which was made the return of the tax in respect of which the liability arises or, if no return was made, then by the United States Court of Appeals for the District of Columbia. * * *

(c) Powers:

(1) To affirm, modify, or reverse. Upon such review, such courts shall have power to affirm or, if the decision of the Tax Court is not in accordance with law, to modify or to reverse the decision of the Tax Court, with or without remanding the case for a rehearing, as justice may require. * * *

California Civil Code:

Sec. 2400. Partnership Defined:

(1) A partnership is an association of two or more persons to carry on as co-owners a business for profit. (2) But any association formed under any other statute of this State, or any statute adopted by authority, other than the authority of this State, is not a partnership under this Act, unless such association would have been a partnership in this State prior to the adoption of this Act; but this Act shall apply to special and mining partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith.

Sec. 2419. Nature of a Partner's Right in Specific Partnership Property.

(1) A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership.

(2) The incidents of this tenancy are such that:

(a) A partner, subject to the provisions of this act and to any agreement between the partners, has an equal right with his partners to possess specific partnership property for partnership purposes; but he has no right to possess such property for any other purpose without the consent of his partners.
(b) A partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property.
(c) A partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership. When partnership property is attached for a partnership debt the partners, or any of them, or the representatives of a deceased partner, cannot claim any right under the homestead or exemption laws.
(d) On the death of a partner his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when his right in such property vests in his legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.
(e) A partner's right in specific partnership property is not subject to dower, curtsey, or allowances to widows, heirs, or next of kin and is not community property.

Sec. 2421. Assignment of Partner's Interest.

(1) A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee, during the continuance

of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.

(2) In case of a dissolution of the partnership, the assignee is entitled to receive his assignor's interest and may require an account from the date only of the last account agreed to by all the partners.

Sec. 2425. Causes of Dissolution.

Dissolution is caused:

(1) Without violation of the agreement between the partners,

(a) By the termination of the definite term or particular undertaking specified in the agreement,
(b) By the express will of any partner when no definite term or particular undertaking is specified,
(c) By the express will of all the partners who have not assigned their interests or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking,
(d) By the expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners;

(2) In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time;

(3) By any event which makes it unlawful for the business of the partnership to be carried on or for the members to carry it on in partnership;

(4) By the death of any partner;

(5) By the bankruptcy of any partner or the partnership;

(6) By decree of court under section 2426.